

DELAWARE STATE LOTTERY

Basic Financial Statements

Years ended June 30, 2005 and 2004 with Report of Independent Auditors

Delaware State Lottery

Basic Financial Statements

Years ended June 30, 2005 and 2004

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Report of Independent Auditors

Wayne Lemons, Director of the Delaware State Lottery and
Richard S. Cordrey, Secretary of Finance, State of Delaware

We have audited the accompanying balance sheets of the Delaware State Lottery (the Lottery) as of June 30, 2005 and 2004, and the related statements of revenue, expenses and change in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Delaware State Lottery's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Delaware State Lottery as of June 30, 2005 and 2004, and its changes in financial position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 1, 2005, on our consideration of the Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplemental information. However, we did not audit the information and express no opinion on it.

Ernst & Young LLP

September 1, 2005

Report on Internal Control over Financial Reporting
and on Compliance and Other Matters Based on
an Audit of Financial Statements Performed in
Accordance with *Government Auditing Standards*

Wayne Lemons, Director of the Delaware State Lottery and
Richard S. Cordrey, Secretary of Finance, State of Delaware

We have audited the financial statements of the Delaware State Lottery (the Lottery) as of and for the years ended June 30, 2005 and 2004, and have issued our report thereon dated September 1, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Secretary of Finance, Lottery management, the Office of the Governor, the Office of the Controller General, the Office of the Attorney General, the Office of Management and Budget, and the Office of the Auditor of Accounts, and is not intended to be and should not be used by anyone other than these specified parties. However, under 29 Del. C., Section 10002(d), this report is public record and its distribution is not limited.

Ernst + Young LLP

September 1, 2005

Delaware State Lottery

Management's Discussion and Analysis

June 30, 2005

The management of the Delaware State Lottery (hereinafter referred to as the Lottery) offers this narrative overview and analysis of the Lottery's financial activities for the year ended June 30, 2005, which should be read in conjunction with the Lottery's basic financial statements.

Overview of the Basic Financial Statements

This discussion and analysis is intended to serve as an introduction to the Lottery's basic financial statements. Since the Lottery is an enterprise fund of the State of Delaware, these financial statements are presented in a manner similar to a private-sector business. As required by accounting principles generally accepted in the United States (GAAP), current year's revenues are recorded when earned and expenses are recorded as they are incurred, regardless of when the cash is received or disbursed.

The balance sheet presents information on all of the Lottery's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets serve as a relative indicator of the change in financial position of the Lottery.

The statement of revenue, expenses and change in net assets shows the result of the Lottery's total operations during the fiscal year and reflects both operating and nonoperating activities. Changes in net assets (increases or decreases) reflect the current fiscal period's operating impact upon the overall financial position of the Lottery.

The statement of cash flows provides a detailed analysis of all sources and uses of cash. The direct method of cash flows is presented, ending with a reconciliation of operating income to net cash provided by operating activities. The statement of cash flows is divided into four activities sections—operating, noncapital financing, capital financing, and investing.

Notes to the basic financial statements contain additional information, and often offer explanations to the basic financial statements. The notes are intended to assist the reader in understanding the Lottery's basic financial statements.

Delaware State Lottery

Management's Discussion and Analysis (continued)

COMPARATIVE CONDENSED BALANCE SHEETS:

Table 1
Comparative Balance Sheets
(In millions)

	2005	June 30 2004	2003
Assets			
Cash and cash equivalents	\$ 5.8	\$ 10.9	\$ 4.6
Accounts receivable, net of allowance of \$.7, \$.7 and \$.7, respectively	6.4	4.5	13.7
Investments	9.9	11.8	14.9
Prepaid expenses	.5	.4	.4
Capital assets, net	.2	.3	.4
Deposit with Multi-State Lottery	1.7	1.7	1.8
Total assets	<u>\$ 24.5</u>	<u>\$ 29.6</u>	<u>\$ 35.8</u>
Liabilities and net assets			
Liabilities:			
Prizes liability, including \$9.9, \$11.8 and \$14.9, respectively, of prize installment obligation	\$ 13.0	\$ 17.1	\$ 24.2
Accounts payable and accrued liabilities	4.5	8.5	7.5
Multi-State Lottery Reserve	1.7	1.7	1.8
Due to the State of Delaware	4.4	1.7	1.4
Total liabilities	<u>23.6</u>	<u>29.0</u>	<u>34.9</u>
Net assets:			
Invested in capital assets	.2	.3	.4
Unrestricted	.7	.3	.5
Total net assets	<u>.9</u>	<u>.6</u>	<u>.9</u>
Total liabilities and net assets	<u>\$ 24.5</u>	<u>\$ 29.6</u>	<u>\$ 35.8</u>

As shown in Table 1 above, the Lottery's total assets, total liabilities and net assets decreased from 2003 to 2004 and decreased from 2004 to 2005. This is due to a number of factors. While for fiscal 2005 and 2003, the portion of Video Lottery revenues

Delaware State Lottery

Management's Discussion and Analysis (continued)

designated for distribution as commissions were paid out by year-end, in fiscal 2004 they remained on hand. This amount for fiscal 2004 was approximately \$5.2 million.

The Lottery's accounting periods are predicated on a 4-4-5 week cycle except at year end when the closing date includes additional days up to and including June 30th. Four additional days were included in fiscal 2005 as opposed to three days in fiscal 2004 and eight days in fiscal 2003. This one-day increase in 2005 accounted for the \$1.9 million increase in Accounts Receivable and the five-day reduction in fiscal 2004 accounted for the \$9.2 million decrease in Accounts Receivable.

The reductions of \$1.9 million in 2005 from 2004 and \$3.1 million in 2004 over 2003 in the Investments account represent installment prize payments made to previous winners of annuity prizes.

Prizes liability for 2005 decreased by \$4.1 million from 2004. This decrease is to some extent due to the liability for the Lotto game. Prizes liability for 2004 decreased by \$7.1 million from 2003. At the end of fiscal 2004, the Lotto jackpot was \$1.5 million compared to \$96,000 at the end of fiscal 2005. The obligation for the Lotto game at the end of fiscal 2003 included \$5 million for an unclaimed Lotto jackpot prize that was won during fiscal 2003 and expired in fiscal 2004. This combined with the reduction in prize installment obligation would account for the decrease.

REVENUE:

Table 2
Revenue
(In millions)

	Year ended June 30		
	2005	2004	2003
Play 3	\$ 27.6	\$ 28.0	\$ 26.9
Play 4	16.8	16.7	15.7
Multi Win Lotto	4.0	—	—
Lotto	11.5	8.9	12.3
Powerball	24.2	28.6	24.4
Powerplay	1.3	1.4	.8
Instant games	28.7	25.0	22.3
Traditional games revenue	114.1	108.6	102.4
Video lottery, net	575.2	532.3	525.7
Total revenue	\$ 689.3	\$ 640.9	\$ 628.1

Delaware State Lottery

Management's Discussion and Analysis (continued)

Table 2 above compares revenue for each lottery game category. Total Lottery Revenue for fiscal year 2005 was \$48.4 million or nearly 8% higher than for fiscal 2004. Fiscal 2004 ended with total Lottery Revenues increasing by \$12.8 million or 2% from 2003.

2005 sales of the Lotto game increased by \$2.6 million or 29.2% over 2004. During fiscal 2005, the Lotto jackpot grew to a record \$7.8 million, which generated a considerable amount of player interest, thus driving up sales. During fiscal 2003, the Lotto jackpot grew to a then record of \$5 million. In contrast, the highest jackpot in 2004 was \$1.5 million. The lack of a substantial jackpot in 2004 would account for the \$3.4 million or 38.2% decrease in sales from 2003.

2005 sales of Powerball/Powerplay decreased \$4.5 million or 18% from 2004 and 2004 sales increased by \$4.8 million or 19% over 2003. During fiscal 2004, Powerball jackpots grew to over \$200 million on three separate occasions. In contrast, the jackpot grew to over \$200 million only once during 2003 and 2005.

2005 revenues for instant games increased by \$3.7 million or 14.8% over 2004 and 2004 revenues increased by \$2.7 million or 12.2% over 2003. The "cooperative services" agreement that the Lottery signed with its vendor for instant games continued to produce positive results. The vendor, in conjunction with the Lottery, continued to offer more attractive products and more products in general. The Lottery also decided to shorten the life cycle of games offered, and increased the introduction of higher price point tickets as surveys indicated that higher price points with higher prize levels were more attractive to the playing public.

2005 Video Lottery revenue increased by \$42.9 million or 8.1% from 2004. This increase can be attributed to a full year of revenue from additional video lottery machines at playing venues and extended operating hours at the facilities. 2004 Video Lottery revenue increased by \$6.6 million or 1.3% from 2003. This increase can also be attributed to a partial year of revenue from additional video lottery machines at the playing venues.

Delaware State Lottery

Management's Discussion and Analysis (continued)

COST OF GAMES:

Table 3
Cost of Games
(As a % of Sales)

	Year ended June 30		
	2005 % of Sales	2004 % of Sales	2003 % of Sales
Commission expense	40.9%	40.8%	41.5%
Gaming vendor fees and costs	5.7%	5.7%	5.4%
Prize expense	8.7%	8.3%	8.4%

Commission expense includes payments to Lottery retailers for selling lottery tickets and to Video Lottery agents for operation of video lottery facilities. Commission expense as a percent of sales remained relatively unchanged for all three years.

Gaming vendor fees and costs include costs of the central system used to monitor and collect pertinent data for the on-line and the video lottery system and costs of leasing video lottery terminals from gaming vendors. Gaming vendor fees and costs remained relatively unchanged as a percent of sales for all three years.

PRIZE EXPENSE:

Table 4
Prize Expense, Net of Reversions
(In millions)

	Year ended June 30		
	2005	2004	2003
Play 3	\$ 12.5	\$ 15.0	\$ 13.0
Play 4	8.0	7.8	8.2
Multi Win Lotto	2.5	—	—
Lotto	7.0	.8	8.1
Powerball	11.3	13.8	9.5
Powerplay	.6	.7	.4
Instant games	17.9	15.1	13.5
Total prize expense	\$ 59.8	\$ 53.2	\$ 52.7

Delaware State Lottery

Management's Discussion and Analysis (continued)

Table 4 above compares prize expense for each Lottery game category for the past three years. In general, prize expense by game will increase or decrease from year to year in proportion to the increase or decrease in sales for a particular game. However, the prize expenses for the Play 3 and Play 4 games are impacted by the luck of the draw and actual prize payment is determined by lottery players' luck in matching the particular set of numbers randomly selected in each drawing for each game. Prize expense for the instant game product category is controllable for the most part, by printing a predetermined number and value of winning tickets for each instant game.

Prize expense in 2005 for the Lotto game increased by \$6.2 million over 2004 and decreased by \$7.3 million from 2003 to 2004. 2003 had a \$5 million jackpot that went unclaimed and was reversed in 2004. This accounted for the low expense level in 2004.

Prize expense in 2005 for the Powerball game decreased \$2.5 million or 22.1% from 2004 and increased \$4.3 million or 45.2% over 2003. Part of this can be explained by the decrease in sales in 2005 from 2004 and the increase in sales in 2004 over 2003 and the balance was due to unclaimed prize reversions, which were high (\$2.6 million) during 2003 compared to only \$708,400 in 2004 and \$802,300 in 2005.

Instant games prize expense increased 18% in 2005 from 2004 and 12% from 2003 to 2004. This is consistent with the increases in sales during those periods coupled with the emphasis on sales of games with higher prize points. Generally, games with higher prize points pay out more in prizes.

OPERATING EXPENSES:

Table 5
Operating Expenses
(In millions)

	Year ended June 30		
	2005	2004	2003
Operating expenses	\$ 7.2	\$ 5.6	\$ 6.3

Operating expenses show a decrease from 1.02% of sales in 2003 to .9% in 2004. A statewide hiring freeze, the discontinuation of certain hardware/software maintenance agreements and the termination of the televised drawing contract contributed to this decrease. In fiscal 2005, however, operating expenses increased to 1.04% of sales. The main reason for the increase is the fixed usage fee that the Lottery is required to pay for the newly installed franchise games at the State's three video lottery facilities.

Delaware State Lottery

Management's Discussion and Analysis (continued)

NONOPERATING EXPENSES:

Table 6
Nonoperating Expenses
(In millions)

	Year ended June 30		
	2005	2004	2003
Contributions to the Delaware Standardbred Breeder's Program	\$ 3.0	\$ 3.0	\$ 2.0
Contributions to the State of Delaware	297.9	281.2	271.8
Total Nonoperating Expenses	<u>\$ 300.9</u>	<u>\$ 284.2</u>	<u>\$ 273.8</u>

Cash contributions to the State General Fund were consistent with Lottery revenue increases. Revenues increased in both 2004 and 2005, thus, the increases in 2004 and 2005 cash contributions.

Delaware State Lottery
Comparative Balance Sheets

	June 30	
	2005	2004
Assets		
Current assets:		
Cash and cash equivalents	\$ 5,803,835	\$ 10,848,294
Accounts receivable, net of allowance of \$705,122 and \$679,229, respectively	6,443,582	4,538,776
Investments – restricted for payment of prize liabilities	2,456,758	2,468,373
Prepaid expenses	488,514	422,702
Total current assets	15,192,689	18,278,145
Capital assets, net	199,192	329,553
Investments – restricted for payment of prize liabilities	7,394,490	9,317,557
Deposit with Multi-State Lottery	1,700,747	1,717,955
Total noncurrent assets	9,294,429	11,365,065
Total assets	<u>\$ 24,487,118</u>	<u>\$ 29,643,210</u>
Liabilities and net assets		
Current liabilities:		
Prizes liability, including \$2,456,758 and \$2,468,373, respectively, of prize installment obligations	\$ 5,540,534	\$ 7,780,222
Accounts payable and accrued liabilities	4,532,331	8,477,674
Due to the State of Delaware	4,385,113	1,722,566
Total current liabilities	14,457,978	17,980,462
Multi-State Lottery reserve	1,700,747	1,717,955
Prize installment obligations, noncurrent	7,394,490	9,317,557
Total liabilities	23,553,215	29,015,974
Net assets:		
Invested in capital assets	199,192	329,553
Unrestricted	734,711	297,683
Total net assets	933,903	627,236
Total liabilities and net assets	<u>\$ 24,487,118</u>	<u>\$ 29,643,210</u>

See accompanying notes.

Delaware State Lottery

Statements of Revenue, Expenses and Change in Net Assets

	Year ended June 30	
	2005	2004
Revenue		
Video lottery, net	\$ 575,234,109	\$ 532,312,673
On-line games, net	85,361,356	83,600,787
Instant games, net	28,695,737	25,011,807
Total revenue	689,291,202	640,925,267
Cost of games		
Video lottery commissions	274,662,888	254,937,728
Prize costs, net of reversions	59,829,996	53,190,946
Gaming vendor fees and costs	39,308,123	36,626,439
On-line and instant games commissions	7,062,069	6,600,986
Sales aids	8,895	28,132
Total cost of games	380,871,971	351,384,231
Gross profit	308,419,231	289,541,036
Operating expenses		
Advertising and promotions	2,517,481	2,499,704
Payroll and related benefits	1,569,045	1,431,071
Other general and administrative	2,974,011	1,640,032
Depreciation expense	130,361	55,437
Total operating expenses	7,190,898	5,626,244
Operating income	301,228,333	283,914,792
Nonoperating expenses		
Contributions to the Delaware Standardbred Breeder's Program	3,000,000	3,000,000
Contributions to the State of Delaware	297,921,666	281,188,496
Change in net assets	306,667	(273,704)
Net assets at beginning of year	627,236	900,940
Net assets at end of year	\$ 933,903	\$ 627,236

See accompanying notes.

Delaware State Lottery

Statements of Cash Flows

	Year ended June 30	
	2005	2004
Cash flows from operating activities		
Receipts from customers	\$ 687,386,396	\$ 650,024,548
Payments to vendors for goods and services	(44,579,856)	(41,466,571)
Payments to employees for services	(1,512,367)	(1,441,478)
Payments for prizes	(63,992,751)	(60,291,067)
Payments for commissions	(286,021,446)	(259,907,677)
Net cash provided by operating activities	<u>291,279,976</u>	<u>286,917,755</u>
Cash flows from noncapital financing activities		
Contributions to the Delaware Standardbred Breeder's Program	(3,000,000)	(3,000,000)
Contributions to the State of Delaware	(295,259,119)	(280,837,212)
Net cash used in noncapital financing activities	<u>(298,259,119)</u>	<u>(283,837,212)</u>
Cash flows from investing activities		
Proceeds from maturity of investments	1,934,684	3,154,540
Net cash provided by investing activities	<u>1,934,684</u>	<u>3,154,540</u>
Net (decrease) increase in cash and cash equivalents	(5,044,459)	6,235,083
Cash and cash equivalents at beginning of year	10,848,294	4,613,211
Cash and cash equivalents at end of year	<u>\$ 5,803,835</u>	<u>\$ 10,848,294</u>
Reconciliation of operating income to net cash from operating activities		
Operating income	\$ 301,228,333	\$ 283,914,792
Adjustments to reconcile operating income to net cash from operating activities:		
Depreciation expense	130,361	55,437
Effect from changes in operating assets and liabilities:		
Accounts receivable, net	(1,904,806)	9,099,281
Deposit with Multi-State Lottery	17,208	77,024
Prepaid expenses	(65,812)	2,644
Prizes liability	(4,162,755)	(7,100,121)
Accounts payable and accrued liabilities	(3,962,553)	868,698
Net cash provided by operating activities	<u>\$ 291,279,976</u>	<u>\$ 286,917,755</u>

See accompanying notes.

Delaware State Lottery
Notes to Financial Statements

June 30, 2005

1. Summary of Significant Accounting Policies

Legislative Enactment

The Delaware State Lottery (the Lottery) was established by Enabling Legislation (the Legislation) passed on May 31, 1974, by the General Assembly of the State of Delaware (the General Assembly) under the authority of the Governor's Office and under the supervision of a Director. In July 1976, the Lottery was transferred to the Office of the Secretary of Finance. The Director has the power and duty to establish rules for conducting games, including the type and number of games, the price of tickets, the number and amounts of winning tickets, the manner of selecting winning tickets, the manner of prize payment, frequency of drawings, locations and methods for the sale of tickets, procedures for licensing of retailers and all other functions related to the operation of the Lottery.

The Legislation provides that for the non-video lottery games at least 45% of total revenue shall be used to pay prizes, operating expenses shall not exceed 20% of total revenue and at least 30% of total revenue will be paid to the General Fund of the State of Delaware (the State). Enabling legislation for video lottery was enacted on July 16, 1994 and provides that for the video lottery games at least 87%, but not more than 95% (unless approved by the Director), of total proceeds on an average annual basis shall be used to pay prizes.

Reporting Entity

The Delaware State Lottery (reporting entity) is an enterprise fund of the State of Delaware.

Basis of Presentation

In accordance with accounting principles generally accepted in the United States, the financial statements are prepared on the accrual basis of accounting, which requires recognition of revenues when earned and expenses when incurred. The Lottery has elected not to apply all Financial Accounting Standards Board statements and interpretations issued after November 30, 1989, in accordance with Government Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*.

Delaware State Lottery

Notes to Financial Statements (continued)

1. Summary of Significant Accounting Policies (continued)

Cash and Cash Equivalents

Cash and cash equivalents consist of deposits held in bank accounts and highly liquid overnight investment accounts, as well as deposits held by the State of Delaware to fund future non-prize costs during the next month.

Accounts Receivable

Accounts receivable consist primarily of unsettled balances due to the Lottery from the racetracks for video lottery, and from retailers, which principally include grocery and convenience stores serving as the primary distribution channel for traditional lottery sales (on-line and instant games) to the general public.

Receivables:

Accounts	\$ 7,148,704
Total receivables	7,148,704
Allowance for doubtful accounts	(705,122)
Total receivables, net	<u>\$ 6,443,582</u>
Amounts not scheduled for collection during the subsequent year	<u>\$ —</u>

Investments

The Lottery has no formal investment policy. Investments consist of annuity contracts purchased from insurance companies to fund future prize payments, and are carried at the present value of future installment prize payments, utilizing a guaranteed interest rate of approximately 4%. The practice of purchasing and holding annuity contracts to fund future prize obligations is no longer employed by the Lottery, as investment amounts reported represent annuity contracts whose most recent purchase was during 1993. It is the Lottery's policy to hold all investments of this nature that were purchased to fund prize obligations until maturity. All investments will have matured as of February 16, 2018; at which time such investments will no longer be reported by the Lottery.

Capital Assets

All purchases of capital assets, mostly computer equipment and furniture and fixtures, in excess of \$15,000 are capitalized and carried at cost. Depreciation is computed by using the straight-line method over the estimated useful life of ten years. When assets are

Delaware State Lottery

Notes to Financial Statements (continued)

1. Summary of Significant Accounting Policies (continued)

Capital Assets (continued)

retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal.

Revenue Recognition

Revenue from on-line games is recognized on the day of the drawing. Revenue from the sale of instant tickets is recognized when the book has been activated and when one of the following occurs:

- 85% of the related prizes of an activated book is paid;
- 90 days from the date of activation; or
- when the next pack of the same game is activated.

Revenue from video lottery sales is recognized, net of prizes paid, at the time the public plays the game.

All revenue that the Lottery reports is considered operating revenue.

Prize Obligations

Prize obligations for the on-line games are determined and recognized after each drawing is held. For the numbers games, winners are paid a certain amount depending upon the number of, or order of, winning numbers. Of every Lotto sales dollar a fixed payment goes to fund prizes to the 4 and 5 numbers of 38 number winners with the balance going into the jackpot. If there are no jackpot winners in the Lotto game, the amount is carried forward until there is a winner. For the Powerball, 50% of the revenues are allocated to the prize pool.

Prize obligations related to instant games in existence prior to 2004 are recognized monthly by multiplying the applicable game's prize percentage by the revenue recognized for the month. Prize obligations related to instant games that began in 2004 are recognized by taking the greater of prize cash disbursements or the historical estimates used by instant games prior to 2004. Disbursements for prizes, including

Delaware State Lottery

Notes to Financial Statements (continued)

1. Summary of Significant Accounting Policies (continued)

Prize Obligations (continued)

installment prize awards, are charged against the obligations for unpaid prize awards. Prizes unclaimed after one year revert back to the Lottery and reduce the prize costs for the year. Such unclaimed monies are then remitted to the State of Delaware.

Compensated Absences

The Lottery has accrued a liability included in accounts payable and accrued liabilities for future absences, recognizing the obligation relating to services already rendered. This liability represents benefits accrued to Lottery employees for vacation earned as of year-end and sick leave estimated to be paid out at retirement for services rendered as of June 30, 2005. Employees earn from 1.25 to 1.75 days of vacation leave per month depending on years of service. The employee or his estate is paid for unused vacation upon termination of employment. Employees earn 1.25 days of sick leave per month. The Lottery's obligation for sick leave credit is a maximum of 45 workdays. As of June 30, 2005 and 2004, the Lottery had liabilities of \$111,268 and \$101,573 for accrued vacation and \$126,472 and \$120,788 for accrued sick leave, respectively.

Operating and Nonoperating Expenses

Operating expenses generally result from providing services and producing and delivering goods in connection with the Lottery's principal ongoing operations. Operating Expenses of the Lottery include personnel costs, contracted services, supplies, and depreciation. All expenses not meeting this definition are reported as non-operating expenses.

Delaware State Lottery

Notes to Financial Statements (continued)

1. Summary of Significant Accounting Policies (continued)

New Accounting Pronouncements

In March 2003, the GASB issued Statement No. 40, "Deposit and Investment Risk Disclosures." GASB Statement No. 40 amends GASB Statement No. 3, *Deposits with Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements*. The Lottery is required to adopt GASB Statement No. 40 for its 2005 financial statements. The disclosures related to this pronouncement are reflected in Note 2 "Cash" and Note 3 "Investments" to the financial statements.

2. Cash

Cash and Cash Equivalents reported reflect three types of account balances: The Lottery Deposit Account, the Lottery Prize Account, and Deposits Held by the State of Delaware. Cash receipts and all cash transfers to other State agencies are made in and out of the Lottery Deposit Account. Prize disbursements are made out of the Lottery Prize Account. Cash held by the State of Delaware (Treasurer's Office), while identified for the Lottery, is maintained in an internal investment pool controlled by the State of Delaware.

Cash balances consisted of the following:

	June 30	
	2005	2004
On hand and in bank	\$ 4,366,625	\$ 9,698,470
Held by State of Delaware	1,437,210	1,149,824
	<u>\$ 5,803,835</u>	<u>\$ 10,848,294</u>

Custodial Credit Risk

All deposits are required by State of Delaware law to be collateralized by direct obligations of, or obligations guaranteed by, the United States of America or other suitable obligations as determined by the State of Delaware's Cash Management Policy Board (the Board), unless the Board shall find such collateralization not in the best interest of the State. Additionally, the Board has determined that deposits need not be collateralized provided they are held in a bank that for the previous two years has had a

Delaware State Lottery

Notes to Financial Statements (continued)

2. Cash (continued)

Custodial Credit Risk (continued)

return on total average assets of 0.5% or greater and has had an average capital ratio (total equity to total assets) of at least 5%. If the bank does not meet the aforementioned criteria, collateral must consist of one or more of the following:

- U.S. Government Securities;
- U.S. Government Agency Securities;
- Federal Home Loan Board Letters of Credit;
- State of Delaware Securities; or
- Securities of a political subdivision of the State of Delaware with a Moody's Investors service rating of "A" or better.

In addition, the bank must ensure that those securities pledged as collateral have a market value equal to or greater than 102% of the ledger balance(s) in the account(s) each day and ensure that securities pledged are identified as held in the State of Delaware's name and are segregated on the bank's records.

At June 30, 2005 and 2004, the bank in which amounts representing Deposits and Cash On Hand are maintained met the aforementioned State-mandated standards; thus alleviating the need for collateralization. Also, at June 30, 2005 and 2004, the financial institutions maintaining the State of Delaware's internal investment pool satisfied the aforementioned criteria; thus, the investments managed by those institutions do not require collateralization.

As of June 30, 2005 and 2004, the total bank balance of cash in all bank accounts was \$4,481,898 and \$9,793,056, respectively.

Delaware State Lottery

Notes to Financial Statements (continued)

3. Investments

Until April of 1998, annuity contracts were purchased from insurance companies to fund prizes of \$150,000 or more; payable on an installment basis. All investments reported on the balance sheet represent such annuities, and are carried on the balance sheet at fair value, which represents the present value of future installment prize payments utilizing a guaranteed interest rate of approximately 4% (payable to prize winners). The fair value of some of these investments is not easily determinable; however, it is the Lottery's intent to hold the investments until maturity. The Lottery remains liable for future periodic payments of deferred prize obligations (approximately \$9.9 million as of June 30, 2005) in the event that annuity issuers default on their obligations. Lottery investments as of June 30, 2005 and 2004 are considered uncategorized investments in accordance with GASB Statement No. 3, *Deposits with Financial Institutions Investment (including Repurchase Agreements)*, and *Reserve Repurchase Agreement*, and GASB Statement No. 40, *Deposit and Investment Risk Disclosures*.

As of June 30, 2005, the Lottery's investments had the following maturities:

	Less than 1 Year	1 – 5 Years	6 – 10 Years	Total
Annuity contracts	\$ 60,627	\$ 4,300,046	\$ 5,490,575	\$ 9,851,248

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates of debt instruments will adversely affect the value of an investment. Investments reported on the balance sheet are not subject to interest rate risk.

Delaware State Lottery

Notes to Financial Statements (continued)

3. Investments (continued)

Credit Risk and Concentration of Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. While the Lottery no longer utilizes the purchase of annuity contracts to fulfill prize obligations, the Lottery places no limit on the amount it may invest in any one issuer. As of June 30, 2005, the insurance companies with which the Lottery's investments in annuity contracts to pay future prize obligations are held were rated by A.M. Best Company and concentrated as follows:

Insurance Company	Total Annuity Contract Values	Concentration	A.M. Best Rating
AIG Annuity Insurance Company	\$ 122,201	1.24%	aa- (superior)
Jefferson-Pilot Life Insurance Company	4,739,474	48.11%	aa+ (superior)
John Hancock Life Insurance Company	465,693	4.73%	aa+ (superior)
Metropolitan Life Insurance Company	2,489,273	25.27%	aa (superior)
Mutual of America Life Insurance Co.	1,006,376	10.22%	A+ (excellent)
New York Life Insurance Company	365,076	3.70%	aa+ (superior)
Ohio National Life Insurance Company	663,155	6.73%	aa- (superior)
Total investments in annuity contracts	<u>\$ 9,851,248</u>	<u>100.00%</u>	

Delaware State Lottery

Notes to Financial Statements (continued)

4. Capital Assets

	Beginning Balance July 1, 2004	Increase	Decrease	Ending Balance June 30, 2005
Capital assets being depreciated:				
Computer equipment and software	\$ 1,394,887	\$ —	\$ —	\$ 1,394,887
Total capital assets being depreciated	1,394,887	—	—	1,394,887
Less accumulated depreciation	1,065,334	130,361	—	1,195,695
Total capital assets being depreciated, net	<u>\$ 329,553</u>			<u>\$ 199,192</u>

	Beginning Balance July 1, 2003	Increase	Decrease	Ending Balance June 30, 2004
Capital assets being depreciated:				
Computer equipment and software	\$ 1,394,887	\$ —	\$ —	\$ 1,394,887
Total capital assets being depreciated	1,394,887	—	—	1,394,887
Less accumulated depreciation	1,009,897	55,437	—	1,065,334
Total capital assets being depreciated, net	<u>\$ 384,990</u>			<u>\$ 329,553</u>

During the year ended June 30, 2005, the Lottery had no purchases or disposals of capital assets. Depreciation expense for the years ended June 30, 2005 and 2004 was \$130,361 and \$55,437, respectively.

Delaware State Lottery

Notes to Financial Statements (continued)

5. Prize Obligations

The following is a reconciliation of changes in the prize liability account, which includes the present value of prize installment obligations, for the fiscal years ended June 30, 2005 and 2004:

	<u>2005</u>	<u>2004</u>
Prize obligations, beginning of year	\$ 17,097,779	\$ 24,197,900
Prize payments	(63,992,751)	(60,291,067)
Prize costs, net of reversions	59,829,996	53,190,946
Prize obligations, end of year	<u>\$ 12,935,024</u>	<u>\$ 17,097,779</u>

The Lottery pays the winners of certain jackpots in annual installments over periods that vary generally from 14 to 20 years. The future prize installment obligations payable as of June 30, 2005, and during the next five years and thereafter are as follows:

2006	\$ 2,497,750
2007	2,347,450
2008	2,151,350
2009	1,837,200
2010	1,384,575
Thereafter (less than five years)	<u>2,107,925</u>
Total payments for unpaid prize installment obligations	12,326,250
Less imputed interest	<u>(2,475,002)</u>
Present value of prize installment obligations	<u>\$ 9,851,248</u>

6. Participation in the Multi-State Lottery

The Lottery is a member of the Multi-State Lottery (MUSL), which operates on-line games on behalf of participating state lotteries. Each MUSL member sells game tickets through its agents and makes weekly wire transfers to the MUSL in an amount equivalent to the member's share of the estimated grand prize liability. Each MUSL member pays lesser prizes directly to the winners. The MUSL operates the Powerball games, as well as the Powerplay feature associated with Powerball. Participating lotteries are required to maintain deposits with MUSL for contingency reserves to protect MUSL from unforeseen prize liabilities. The money in this reserve fund is refundable to MUSL members if the MUSL disbands or if a member leaves the MUSL Board.

Delaware State Lottery

Notes to Financial Statements (continued)

6. Participation in the Multi-State Lottery (continued)

The amount the Lottery had on deposit with MUSL, as of June 30, 2005 and 2004, equaled \$1,700,747 and \$1,717,955, respectively. These amounts are also reported as a liability on Lottery's balance sheet because they represent the amount to be paid to the State upon separation from the MUSL if the MUSL is not required to use a portion of the Lottery's reserves held by the MUSL.

Complete separate financial statements for the MUSL may be obtained by sending a written request to the Lottery's Administrative Office.

7. Delaware Standardbred Breeder's Program

In March 1998, an amendment to the Legislation was passed by the General Assembly that established the Delaware Standardbred Breeder's Program (the Breeder's Program) for the purpose of promoting the Delaware harness racing industry. Under this amendment, the Lottery was initially required to withhold \$2,000,000 of funds annually (\$1,000,000 from the General Fund of the State and \$1,000,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these fees to the Breeder's Program. Under an amendment signed in April 2004, the Lottery is required to withhold \$3,000,000 of funds annually (\$1,500,000 from the General Fund of the State and \$1,500,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these fees to the Breeder's Program.

Delaware State Lottery

Notes to Financial Statements (continued)

8. Contributions to the State of Delaware

As required, under the Legislation, net assets of the Lottery may not exceed \$1,000,000; therefore, the Lottery periodically transfers surplus funds to the State in accordance with the Legislation. For the years ended June 30, 2005 and 2004, the Lottery made the following contributions to the State of Delaware and, as of June 30, 2005 and 2004, had the following liabilities due to the State for excess earnings:

	June 30	
	2005	2004
Amounts transferred during the fiscal year:		
General Fund	\$ 234,000,000	\$ 222,000,000
Department of Health and Social Services	1,598,174	1,492,540
Department of Agriculture	59,660,945	57,344,672
	<u>295,259,119</u>	<u>280,837,212</u>
Amounts accrued, beginning of year	(1,722,566)	(1,371,282)
Amounts due to the State, end of year:		
General Fund	—	—
Department of Health and Social Services	142,516	130,693
Department of Agriculture	4,242,597	1,591,873
Amounts accrued, end of year	<u>4,385,113</u>	<u>1,722,566</u>
Total contributions to the State of Delaware	<u>\$ 297,921,666</u>	<u>\$ 281,188,496</u>

Delaware State Lottery

Notes to Financial Statements (continued)

9. Revenue and Expenses by Game

The following revenue was recognized:

	Year ended June 30	
	2005	2004
On-line games, net		
Play 3 Day	\$ 9,921,990	\$ 10,075,263
Play 3 Night	17,634,985	17,891,099
Play 4 Day	5,808,552	5,769,689
Play 4 Night	11,017,638	10,942,608
Multi Win Lotto	4,041,601	—
Lotto	11,509,065	8,892,922
Powerball	24,149,196	28,620,494
Powerplay	1,278,329	1,408,712
	85,361,356	83,600,787
Video Lottery, net	575,234,109	532,312,673
Instant	28,695,737	25,011,807
	\$ 689,291,202	\$ 640,925,267

The revenue, prize costs and commissions expense, by game type, are listed below:

	On-line, Net	Video Lottery, Net	Instant, Net	Total
Year ended June 30, 2005				
Revenue	\$ 85,361,356	\$ 575,234,109	\$ 28,695,737	\$ 689,291,202
Prize costs, net of reversions	41,956,466	—	17,873,530	59,829,996
	43,404,890	575,234,109	10,822,207	629,461,206
Commissions expense	5,425,788	274,662,888	1,636,281	281,724,957
Contribution margin per game	\$ 37,979,102	\$ 300,571,221	\$ 9,185,926	\$ 347,736,249
Year ended June 30, 2004				
Revenue	\$ 83,600,787	\$ 532,312,673	\$ 25,011,807	\$ 640,925,267
Prize costs, net of reversions	38,061,211	—	15,129,735	53,190,946
	45,539,576	532,312,673	9,882,072	587,734,321
Commissions expense	5,205,294	254,937,728	1,395,692	261,538,714
Contribution margin per game	\$ 40,334,282	\$ 277,374,945	\$ 8,486,380	\$ 326,195,607

Delaware State Lottery

Notes to Financial Statements (continued)

10. Payroll-Related and Other Benefits

All Lottery personnel are employees of the State and are covered by pension, health insurance and other employee benefit programs administered by agencies of the State. During 2005 and 2004, the Lottery incurred \$1,569,045 and \$1,431,071, respectively, of payroll-related costs, including pension, health insurance and other employee benefit costs, paid to various State of Delaware agencies responsible for the administration of benefit programs.

11. Retirement and Other Postemployment Benefits

The Lottery contributes to the State Employees' Pension Plan (the State Plan) established by the State to provide benefits for State employees. While the State Plan is an agent multiple employer public employee retirement system, the Lottery accounts for the plan as a cost-sharing multiple employer public employees retirement system since a separate valuation is not performed for the Lottery and the Lottery's only obligation to the plan is its required annual contributions. The State Plan is considered part of the State's financial reporting entity, and is not considered as part of the Lottery's reporting entity. The State Plan prepares separate financial statements, which can be obtained by writing to the State Board of Pension Trustees and Office of Pensions, McArdle Building, Suite #1, 860 Silver Lake Boulevard, Dover, Delaware 19904-2402.

The State Plan consists of several plans, which are managed by the State. The various plans have different vesting periods ranging from 5 to 20 years, various eligibility requirements and various benefits that are provided. The Lottery's required contributions, which equaled actual contributions made for the years ended June 30, 2005, 2004 and 2003, were \$139,226, \$113,200 and \$99,200, respectively.

The Lottery's accrued pension costs for the years ended June 30, 2005 and 2004 equaled \$7,835 and \$4,809, respectively, and are included within amounts reported as Accounts Payable and Accrued Liabilities on the balance sheet.

12. Risk Management

The Lottery stipulates in its vendor contracts that the vendors carry various insurance coverages such as property (video gaming machines and online terminals, etc.), general liability, errors and omissions, automotive and crimes. The Lottery's risks of losses related to workers' compensation, employee health care, automobile and a portion of property and casualty claims are insured internally by the State of Delaware.

Delaware State Lottery

Notes to Financial Statements (continued)

13. Commitments

The Lottery has entered into various contracts for services to be rendered relating principally to the operation of the Lottery's games. Under the gaming systems vendor contracts, the Lottery is committed to future obligations.

The Lottery is committed to 4.18% of online sales to its central system provider and 11.6999% of instant sales to another system provider through fiscal year 2008. For video lottery, the Lottery is committed to .7885% to the central system provider through fiscal year 2008 and a percentage ranging from 4.0% to 6.5% to the video lottery terminal providers through June 1, 2007.

The Lottery's commitments to gaming vendors, as described above, comprise the majority of the following commitments. The commitments to gaming vendors included in these commitments are based on management's sales projections for the respective years, as follows:

2006	\$ 40,076,000
2007	34,185,500
2008	8,000,000
2009	2,000,000
2010	—
Thereafter	—